Orten Cavanagh Richmond & Holmes LLC
Attorneys at Law

INSURANCE IN COMMON INTEREST COMMUNITIES

UNDERSTANDING COMMUNITY INSURANCE

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Orten Cavanagh Richmond & Holmes, LLC
Community Association Attorneys

Denver • Phone 720.221.9780 • Fax 720.221.9781
Colorado Springs • Phone 719.457.8420 • Fax 719.457.8419 • Toll Free 888-841-5149
Email: info@ocrhlaw.com • Web: www.ocrhlaw.com

Orten Cavanagh Richmond & Holmes LLC

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INSURANCE IN COMMON INTEREST COMMUNITIES

I. Insurance Required by Documents, State Law or Good Practices.

A. Sources of Insurance Requirements Associations are required by their governing documents and, in some instances, by state law to have certain types of insurance. If insurance is not required by the documents or state law, good practices may dictate the insurance or risk to be covered.

In condominiums and other attached home communities, the association generally has property insurance on the "structures" and has liability insurance on the common areas. In these types of communities, the owners may also have an obligation to insure a portion of the structure of their unit and will be obligated to procure insurance for liability claims in their units and insurance for their personal property. In single family home communities, the owners generally insure all of the property they own including the lot and the structures on the lot for property damage and liability.

B. Types of Insurance

1. Property Insurance
2. Liability Insurance
3. Directors' and Officers' Professional Liability Insurance;
4. Fidelity Insurance
5. Workers Compensation Insurance
6. Specialty Insurance

II. Insurance Requirements

A. Statutory Requirements. The Colorado Common Interest Ownership Act ("CCIOA") is applicable to communities created after July 1, 1992. (C.R.S. §38-33.3-313)

1. Property Insurance

a. Association must maintain property insurance on the common elements for broad form covered causes of loss. This insurance must be for not less than the full insurable replacement cost of the insured property, less applicable deductibles.

b. In the case of a building that contains units having horizontal boundaries (*i.e.,* stacked units); the insurance must include the units, but not the finished surfaces of the walls, floors and ceilings of the units. (Note: this statutory requirement does not apply to townhome style units that are not condominiums.)

2. Liability Insurance.

a. Commercial general liability insurance against claims and liabilities arising in connection with the ownership, existence, use or management of the common elements (and also of units in cooperatives) in an amount, if any, specified by the common interest community instruments or otherwise deemed sufficient in the judgment of the executive board, but not less than any amount specified in the association documents, insuring the executive board, the unit owners' association, the management agent, and their respective employees, agents, and all persons acting as agents.

b. The declarant shall be included as an additional insured in such declarant's capacity as a unit owner and board member.

c. The unit owners shall be included as additional insured, but only for claims and liabilities arising in connection with the ownership, existence, use or management of the common elements and, in cooperatives, also of all units. The insurance shall cover claims of one or more insured parties against other insured parties.

3. Fidelity Insurance. If an association has more than 30 units, it must maintain fidelity insurance of at least two months of operating expenses, plus reserves. Additionally C.R.S. §38-33.3-306 requires that if an association with 30 or more units delegates powers of the executive board or officers relating to collection, deposit, transfer, or disbursement of association funds to other persons or to a managing agent, the bylaws of the association must require the following:

a. that the other persons or managing agent maintain fidelity insurance coverage or a bond in an amount not less than $50,000.00 or such higher amount as the board may require;

b. that the other persons or managing agent maintain all funds and accounts of the association separate from the funds and accounts of other associations managed by the other persons or managing agent and maintain all reserve accounts of each association so managed separate from operational accounts for the association; and

c. that an annual accounting for association funds and a financial statement be prepared and presented to the association by the managing agent, a public accountant or a certified public accountant.

4. Guidelines Not Required, But Allowed Under CCIOA. CCIOA provides that:

a. The association may adopt and establish written nondiscriminatory policies and procedures relating to the submittal of claims, responsibility for deductibles, and any other matters of claims adjustment.

b. To the extent the association settles claims for damages to real property, it has the authority to assess negligent unit owners causing such loss or benefiting from such repair or restoration all deductibles paid by the association.

c. In the event that more than one unit is damaged by a loss, the association in its reasonable discretion may assess each unit owner a pro rata share of any deductible paid by the association.

B. Governing Document Requirements.

1. Pre-CCIOA Associations. All insurance requirements will be in the governing documents. Documents typically require property insurance, liability insurance, directors and officers professional liability insurance and fidelity coverage.

2. Post-CCIOA Associations. Governing documents may restate and/or supplement requirements outlined in CCIOA. Governing documents typically supplement the statutory requirements with directors and officers professional liability coverage, flood insurance, if applicable, and equipment breakdown coverage.

III. Types of Insurance and Related Issues.

A. Property Insurance Issues and Endorsements.

1. Issues to Consider in Reviewing Property Insurance.

a. Blanket Insurance v. Limits by Building. A blanket limit approach is safer than a building by building limit since it is less likely that a particular building will be underinsured.

b. Replacement Cost v. Market Value. Replacement cost is generally approximately 70% of market value. Replacement cost does not include land and typically does not include foundations.

c. Actual Cash Value (ACV) v. Replacement Cost (RCV). Actual cash value is the current value including depreciation. Replacement cost is not subject to depreciation. The association needs replacement cost value.

d. Waiver of Subrogation. Association policies typically provide that the insurer cannot proceed against a negligent owner to recover cost of damage. Typically this waiver of subrogation also extends to the owners family members. In some policies, the waiver of subrogation does not extend to tenants.

e. Association Policy is Primary. If the owner’s policy covers the same damage as the association’s policy, the association’s policy will be primary.

2. Common Endorsements to Property Insurance Policies.

a. Law and Ordinance Coverage. This endorsement has three components:

i. Coverage A. In cases where ordinances may require replacement of the undamaged part of the building, this coverage addresses that increased cost of repair;

ii. Coverage B. This coverage insures for increased cost of demolishing undamaged portion of the building; and

iii. Coverage C. This coverage insures for the increased construction costs to rebuild or repair to current building code requirements (*e.g*., sprinklers, accessibility requirements).

b. Inflation Guard Coverage. This coverage provides that limits of property coverage will increase a specified amount each year to address costs of inflation.

c. Sewer and Drain Backup. Coverage for sewer and drain back-ups into units are typically excluded. If the association wants to have coverage for such events, an endorsement may be required.

d. Equipment Breakdown Coverage (Boiler and Machinery). This covers direct physical loss to equipment such as elevators, pumps, boilers, etc.

3. Flood Insurance. If property is located in a flood zone, lenders will generally require that the association obtain flood insurance. Flood insurance is generally available through the National Flood Insurance Program ("NFIP").

4. Allocation of Insurance Responsibilities between Association and Owners in Communities with Attached Homes (either Townhomes or Stacked Units). Since a casualty in one home may affect a neighboring home, the governing documents for attached homes and stacked unit communities typically require the association to obtain a master association policy that covers certain property owned by individual owners.

a. Types of Property Insurance. There are typically three different approaches for the association's master insurance policy in the insurance market:

i. Bare Walls Concept — this approach provides that an association has no duty to insure a unit inside the unfinished surfaces of the perimeter walls, floors, and ceilings. The owner has the responsibility to insure not only personal property, but partitions, paint, cabinets, and all other property located within the finished surfaces of the perimeter walls, floors, and ceilings.

ii. Single Entity Concept — this approach provides coverage to replace a unit to its condition as originally constructed. This type of policy typically insures paint, partitions, cabinets, plumbing, and fixtures to the quality originally provided by the declarant (*i.e.*, the original developer). It may also cover appliances depending on what was originally installed by the declarant and the association's governing document requirements.

iii. All-in Concept — this approach provides coverage to replace a unit to the condition it was in at the time of the loss, which includes all betterments and improvements made to the unit from the date of its original construction.

b. Ambiguous. Many older declarations are not particularly clear as to which of the above referenced types of coverage may be required.

c. History. Historically, the most common type of insurance was "single entity" insurance. However, in some cases, that coverage evolved to "all-in" coverage. More recently, there has been some movement towards the "bare walls" type policies. In fact, secondary mortgage market underwriter, Fannie Mae, and FHA have modified their guidelines regarding insurance. The Fannie Mae and FHA guidelines now specifically provide that they accept loans in projects with "bare walls" policies as long as there is documentation that the owner has an individual policy to cover the portions of the unit in which the lender has a security interest.

d. Different Philosophies and Approaches.

i. Position Supporting "Bare-Walls" Approach. As premiums for association insurance increase, the less that is covered under the master policy, the fewer the claims and the lower the claims history (which is one of the criteria used to determine premiums). One rationale for limiting the scope of what is covered on the association's policy is that any one owner may not have any claims in a year or may have only a single claim, whereas all owners together are likely to have more claims on the association's policy.

A single claim on the owner's policy is less likely to increase the premium on that owner's policy than multiple claims on the association's policy. Ultimately, the owners will pay for their prorata share of the premium for the association's policy and will also pay for their individual homeowner policy. The goal is to keep the total cost as reasonably low as possible.

ii. Position Supporting "Single-Entity" Approach. Many owners do not maintain individual owner policies, even though the documents may require or advise them to do so. If the owner does not have insurance, and the owner does not have adequate funds to self-insure, the unit may not be rebuilt to the original condition. If the owner does not have adequate funds to finish the interior of the unit, it remains as a shell and can have an economic impact on the rest of the community if the owner has to sell the unit below market

value in the community or even loses it to foreclosure, which typically yields a lower price and may reduce the values for other units in the community.

Another argument in favor of the single-entity approach is that the insurance is for the benefit of the community and all owners should participate in the cost of insuring the property to at least the level of original construction.

iii. All-In Concept. Particularly in older communities, it may be difficult for an owner to know what the level of original construction may have been when modifications have been made over the years. This type of coverage best assures that the unit will be restored to the level it was immediately prior to the loss.

5. Deductibles.

a. Background.

i. Standard Deductible. Historically, deductibles on association policies were fairly low and were rarely an issue. However, as premiums for association master policies have skyrocketed, increasing the deductible has been a standard way of reducing the premium costs, while also reducing the number of small claims on an association's policy. Reducing the number of claims assists in keeping premiums more stable than they would be with a large number of claims. Deductibles now typically range from $1,000.00 to $10,000.00 or, in some cases, even higher.

The declarations for many older communities do not specifically address the allocation of deductibles. In such cases, the association may be able to adopt a policy regarding the allocation of the deductible similar to those that post-CCIOA associations have authority to adopt. In addition, some older declarations establish the amount of the deductible, which limits the association's options when obtaining insurance. (It may be noted that the requirement to maintain insurance for full replacement value is subject to deductibles and the amount of the deductible does not constitute a deficiency in the required insurance.)

ii. Wind or Hail Percentage Deductible. This is a separate, higher deductible provision that applies to loss caused by wind or hail. This deductible is typically a percentage of the value of the damaged property rather than a flat amount. These deductibles typically range from one to three percent of the value of each building damaged.

b. Typical Methods for Allocating Deductibles. Unless prohibited by the governing documents (*i.e.*, governing documents may provide that deductible is a common expense of all owners), deductibles are typically allocated using one of the following methods:

(i) the owner who would have maintenance responsibility in the absence of insurance is responsible for the deductible;

(ii) the owner who has maintenance responsibility for the damaged property in the absence of insurance is responsible for the deductible unless another owner has negligently caused the damage; or

(iii) the owner from whose unit the problem originates is responsible for the deductible, even if the damage is to another unit, whether or not that owner was negligent.

c. Concerns About Higher Deductibles Allocated to Owners. Higher deductibles present an issue for associations and their owners. All homeowners should have their individual policy structured to ensure that there is no gap between the association's policy and their individual policies.

With higher deductibles, owners should consult their individual insurance professionals to request that their individual policy has coverage that will address the difference between their individual deductible and the deductible on the association's policy. When a covered claim is below the deductible on the association's policy, this coverage would also cover the owner for the damages above their personal insurance deductible. For example, if the deductible on the association's policy is $2,500.00 and the owner's personal insurance deductible is $500.00, in an instance where the damages are $2,000.00 the owner's personal insurance should respond to cover $1,500.00 of the $2,000.00 claim (assuming the owner has adequate coverage on the owner's individual policy).

d. Coverage for Deductibles. We understand that different insurance companies approach the deductible issue in different ways.

(i) Some companies will provide coverage under the Coverage A (Dwelling Coverage) portion of the homeowner's individual policy on the basis that the amount not covered due to the deductible is for repair or replacement of part of the dwelling.

(ii) Other companies will cover the deductible under the "loss assessment" portion of a homeowner's policy. In any case, individual homeowners should determine, with their individual agent, whether their individual homeowner policy covers deductibles under the association's master policy.

(iii) The standard form individual homeowner policies typically provide that loss assessments are defined as a charge by the association for each owner to pay for their share of a loss to the association. For example, some insurance policies have a separate wind and hail deductible based on a percentage of the value of the building rather than the standard deductible. This amount will vary depending on the location of the property, the type of roofing and the age of the roofing. As a result, the wind and hail deductible may be substantially higher than $2,500.00 or other deductible. In one community, the deductible for roofing and siding repairs after recent spring hail storms was $130,000.00. If that association had to assess

its owners to pay for that deductible, the assessment would typically be considered a "loss assessment."

(iv) If coverage for the association's deductible is under the Coverage A portion of the policy, the owner should add the amount of the association's deductible to the amount of insurance the owner requires to cover the value of their betterments and improvements, personal property and anything else covered under the Coverage A portion of the owner's policy. If the deductible would be covered as a loss assessment, an endorsement may be required to increase the amount above the typical $1,000.00 coverage limit.

B. Liability Insurance.

1. Components of Liability Insurance.

a. Coverage A. Bodily Injury and Property Damage.

b. Coverage B. Personal Injury and Advertising Injury (*e.g.*, libel, slander, false advertising).

c. Coverage C. Medical Payments to Third Parties, Typically $5,000 (some policies extend this coverage to owners).

2. Coverage Limits. Typically associations have policies with a $1 million per occurrence or $2 million aggregate. Associations should work with their insurance professionals to assess risk and determine if an umbrella policy may be prudent. For example, an association with a pool has greater risk of liability than a community with no amenities.

3. Common Endorsements.

a. Hired and Non-Owned Automobile Coverage. Even if an association has no automobiles, a board member or committee member driving while on association business is covered if the association has such coverage. This is typically secondary to the driver's primary coverage.

b. Host Liquor Liability. Even though the association is not in the business of serving alcohol, this type of coverage is available for events where alcohol may be served if someone is injured by a person who has been drinking at a function where the association served alcohol.

c. Fidelity/Crime/Employee Dishonesty. This type of insurance covers misdeeds by officers, directors, and association employees. If an association has off-site management, it is important to have an endorsement that will cover the management on the association's policy. It is preferable to just state that it will cover the management agent rather than stipulating a specific management company so if management changes and no one changes

the policy, the association will still have covered the management agent. Associations should also review the adequacy of fidelity coverage.

i. CCIOA for post-CCIOA communities requires two months of operating expenses plus the amounts in reserves;

ii. FHA guidelines for condominiums require the association to maintain coverage at least equal to three months of operating expenses plus the amounts in reserves;

iii. Fannie Mae guidelines permit a lower level if certain identified controls are in place, but require coverage in a minimum amount of three months of operating expenses. While these guidelines are not binding on associations, they may have to be met for purchasers to obtain loans insured by these agencies. Some governing documents also set guidelines for coverage.

C. Directors and Officers Liability Insurance (D&O policies). D&O policies should cover wrongful acts that allege mismanagement of association affairs.

1. Scope of Coverage. Not all policies provide the same coverage. We understand that some studies indicate that 75% of claims on D&O policies are non-monetary claims. Therefore, if the policy only covers monetary claims, the association will not have insurance for most claims. Non-monetary claims may include claims by owners over selective enforcement of covenants or architectural restrictions or discrimination claims, among others. Associations should also consider the definition of a "claim" under the policy. Some policies only cover litigation and do not cover arbitration or administrative proceedings. Policies with broad coverage are typically stand alone policies and not part of a package policy.

2. Who is Covered? Associations should look for policies that cover not only the association, its directors and officers, but also committee members and other association volunteers. Associations should also look for coverage that extends to the management agent. Typically management contracts require associations to indemnify the management agent in the event the management agent is sued. Extending coverage to the management agent would provide insurance to fulfill the indemnification obligation for claims covered by the D&O policy.

3. Defense Costs. In evaluating the adequacy of coverage, the association should determine if the policy provides for defense costs inside or outside the policy limits. If defense costs are outside policy limits, the association may have $1 million of coverage plus the cost of defense. If defense costs are inside policy limits, the defense costs are subtracted from the $1 million and the balance is available for claims).

4 Deductibles. These deductibles will be paid by the association; therefore, the association must be self-insured for the deductible amount.

D. Workers' Compensation Insurance.

1. Statutory Insurance. State law requires that employers with one or more full or part-time employees have workers compensation insurance.

2. Associations without Employees. Many associations engage independent contractors to do various services on the property (*i.e.*, landscaping, roofing, snow removal, painting). The contractor should have coverage, but if the contractor does not have insurance, the worker may be eligible for benefits from the association. Associations should consult their insurance professionals to determine whether they should have workers' compensation insurance and, if so, how much.

E. Owner Insurance. Owners are responsible to obtain insurance to supplement the association's policy.

1. Single Family Detached Communities. Typically owners in these communities purchase what is referred to as an HO-3 policy. This type of policy covers the entire structure and its contents as well as liability insurance on the property.

2. Condominiums or Townhomes.

a. Owner Occupied. The type of policy for owners is typically referred to as an HO-6 policy. As noted above, owners should work with their agents to ensure that coverage on the structure is adequate and that they have insurance for deductibles that may be assigned to them as well as for liability insurance in the unit.

b. Investor Owned. The type of policy for non-resident owners is typically referred to as rental condominium policy or landlord's policy. Sometimes an HO-6 policy may be endorsed to cover rental to others. This policy should cover unit coverage, personal property coverage, liability coverage, and loss of rent if the unit must be vacated for repairs.

c. Renters. Renter's policies are known as HO-4 policies and provide coverage for the renter's personal property and liability coverage. These policies may also cover relocation costs in the event the property has to be vacated for repairs.

IV. Recommendations Related to Insurance Maintained or Recommended to be Maintained by the Association

A. Attorney Review of Association Insurance - Written Report. An insurance review by Orten Cavanagh Richmond & Holmes includes a comprehensive analysis and written report of the insurance requirements in the governing documents. We review the governing documents and current insurance to determine whether the coverage in your policies meets the established requirements to sufficiently protect the association.

Our review includes a report on all existing insurance, including:

- General liability
- Property (if any)
- Directors and Officers or Professional liability
- Workers' compensation policies
- Related endorsements
- Other existing policies

Our report includes:

- Our opinion on whether the policies meet the requirements of the governing documents
- Identifies deficiencies and gaps in existing coverage
- Aids the association in determining if it is under or over insured
- Enables the association to avoid paying for uninsured claims or over paying for coverage it does not need
- Aids the association in determining whether to adopt claims guidelines or deductible guidelines

Upon completion of our review, we provide our report and meet with the board to discuss the report, make recommendations and answer any questions. Then, the association, in conjunction with its agent, can best determine how to maintain and manager the insurance carried by the association.

B. Insurance Guidelines. In addition to the insurance review and report, we can provide insurance guidelines that:

- Identify who is responsible for insurance to what portions of the property.
- Delineate the procedure for submission of a claim by a homeowner or by the association, on policies carried by the association
- Clarify who is responsible for paying deductibles
- Explain how gaps in coverage or overlapping insurance provisions are dealt with